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248-657—67

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 954

CBN CORPORATION (FORMERLY COLUMBIAN CARBON COMPANY), PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. A) is reported at 364 F. 2d 393.

JURISDICTION

The judgment of the Court of Claims (Pet. App. A, pp. 1a, 13a) was entered on July 15, 1966. Petitioner's timely motion for a rehearing was denied on October 14, 1966 (R. 294, 295).[1] The petition for a writ of certiorari was filed on January 10, 1967. The jurisdiction of this Court is invoked under 28 U.S.C., 1255(1).

[1] "R." references are to the certified transcript of the record.

QUESTIONS PRESENTED

1. Whether the Court of Claims correctly ruled that petitioner did not acquire an economic interest in natural gas in place, and hence was not entitled to depletion deductions under Sections 611 and 613 of the Internal Revenue Code of 1954.

2. Whether the Court of Claims correctly held that the doctrine of collateral estoppel did not apply with respect to a prior decision in favor of petitioner.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

* * * * *

[26 U.S.C. 611.]

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the

property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). * * *

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * * *

[26 U.S.C. 1964 613.]

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.611–1 *Allowance of deduction for depletion.*

* * * * *

(b) *Economic interest.*—(1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensa-

tion for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

* * * * *

[26 C.F.R. § 1.611–1.]

STATEMENT

The material facts, as set forth in the opinion below (Pet. App. A, pp. 8a–11a), may be summarized as follows:

Prior to 1952, Shamrock Oil and Gas Corporation was engaged in the production of natural gas from lands it owned or leased in Moore County, Texas. CBN Corporation, petitioner here, operated a carbon black plant in the same area. Under various agreements CBN had both the right and the obligation to purchase residue gas from Shamrock. It was Shamrock's responsibility to bring natural gas to the surface, remove the liquid hydrocarbons therefrom and furnish CBN with the remaining dry (residue) gas. Shamrock dedicated a specified fraction of certain gas reserves for the purpose of supplying CBN. In turn, CBN was obligated to purchase on specified terms a minimum of 30 million cubic feet of residue gas per day, and had first option to purchase additional gas from the dedicated reserves. CBN was given the right to resell the residue gas it purchased, rather than burn it in its carbon black plant. On such resale, CBN was to pay Shamrock specified considerations (Pet. App. A, pp. 8a–9a).

By 1952 CBN wished to shut down its carbon black plant and resell all the residue gas it bought from Shamrock. In turn, Shamrock wished to sell such gas to another purchaser at higher profits. Accordingly, the parties entered into a new contract in 1952, which recited in part that:

> Whereas [CBN] has notified Shamrock of its intention to shut down its carbon plant * * * and * * * desires to effect a resale of volumes of gas it is authorized to resell under the terms and provisions of the aforesaid [pre-1952] contracts; * * * and
>
> Whereas * * * the conditions under which such volumes would be delivered and received would require an agreement or arrangement between Shamrock and the purchaser * * *; * * * the parties hereto * * * have concluded that it would be more economical and convenient to arrange for the resale of the aforesaid volumes to be made by Shamrock in its own name and on its responsibility as between the seller and purchaser of such gas and that an accounting between the parties hereto with respect to such resale volumes be made on a basis mutually satisfactory in lieu of the accounting between the parties required under the terms of the aforesaid [pre-1952] contracts * * *; and
>
> Whereas Shamrock is willing to release [CBN] from its obligation to purchase volumes of residue gas it is now obligated to purchase * * * and is willing to undertake to accomplish a resale of the volumes of residue gas which [CBN] is authorized to resell * * * in lieu of making delivery thereof to [CBN], and

> is willing to make certain payments to [CBN] with respect to the volumes of residue gas remaining from gas produced from its sour gas reserves to the extent of the volumes which [CBN] would * * * be authorized to sell to others * * *.

CBN's remuneration for residue gas to be sold by Shamrock to a third party or parties under the new agreement was to be a specified share of Shamrock's new and higher selling price (Pet. App. A. pp. 10a–11a).

Emphasizing that the new contract did not give CBN a leasehold or fee in the land and did not contain any express covenant running with the land, the Court of Claims found that the intention of the parties, reflected in the contract, was to modify their prior agreement only to the extent of having Shamrock sell, in its own name but as CBN's agent, the residue gas which CBN had previously been entitled to purchase and resell (Pet. App. A, p. 11a).

ARGUMENT

1. The question presented on the merits is whether the new contract negotiated between Shamrock and CBN in 1952 had the effect, for tax purposes, of changing CBN's rights as a purchaser of residue gas into a depletable ownership interest in Shamrock's natural gas in place. The Court of Claims held not. This ruling is correct. Moreover, the issue is narrow and essentially factual. Accordingly, further review is not warranted.

Section 611(a) of the 1954 Code, *supra*, p. 2, which authorizes a reasonable allowance for depletion

of oil and gas wells, emphasizes that such allowance depends upon "the peculiar conditions in each case" and is to be governed by "regulations prescribed by the Secretary or his delegate." So far as here pertinent, Treasury Regulations on Income Tax (1954 Code), Section 1.611–1(b)(1), *supra,* pp. 3–4, restricts the depletion allowance to the "owner of an economic interest in mineral deposits," and provides that a taxpayer does not have the requisite ownership interest unless (1) he has "acquired by investment any interest in mineral in place," and (2) also "secures, by any form of legal relationship, income derived from the extraction of the mineral * * * to which he must look for a return of his capital."

CBN's pre-1952 contractual relationship with Shamrock was solely that of a purchaser of the residue gas remaining after Shamrock had processed its natural gas for removal of liquid hydrocarbons. In those circumstances, clearly, CBN did not have a depletable capital investment in Shamrock's natural gas in place; its contractual rights constituted "a mere economic or pecuniary advantage derived from production" (Treasury Regulations on Income Tax (1954 Code), Section 1.611–1(b)(1), *supra,* p. 3). We point out that the distinction in the Treasury Regulations between an "economic interest" and the nondepletable economic advantage a purchaser derives from his contract with an owner stems from this Court's landmark decision in *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, where the Court denied the depletion allowance to a processor who purchased all of the natural gas produced from a certain property.

As the purchaser of a refined product which Shamrock had processed, CBN had an even lesser interest.

In 1952, having decided to close its carbon black plant, CBN was no longer interested in purchasing residue gas for its own use. However, its right to purchase for resale was valuable, and this right was preserved in modified form in the new contract. The contract provided for "the resale * * * by Shamrock in its own name * * * of the volumes of residue gas which [CBN] is authorized to resell" and assigned to CBN a share of the receipts (Pet. App. A, pp. 10a–11a), but it did not purport to transfer from Shamrock to CBN any other right or interest. CBN remained a puchaser, not an owner, of the gas in place; the 1952 contract, in plain terms, was merely a new sales agreement, intended simply to continue CBN's previous contractual right to profit from sales of Shamrock's residue gas.

2. The other question here is whether the doctrine of collateral estoppel requires reversal of the decision below by reason of a 1964 Court of Claims decision involving CBN's taxable year 1953. In that case, a majority of the court recognized that CBN's status prior to 1952 was that of a mere purchaser but held that the 1952 agreement vested in CBN a depletable "economic interest" in the nature of a royalty interest (Pet. App. C). In the instant decision, the court, while acknowledging that the same facts were involved save for a difference in tax years, held that the

bar of collateral estoppel had been lifted by intervening changes in law (Pet. App. A, pp. 2a–8a).

In *Commissioner* v. *Sunnen*, 333 U.S. 591, this Court, noting that the doctrine of collateral estoppel has a much narrower scope than that of *res judicata*, expressed concern lest the doctrine be misapplied to give taxpayers "vested rights" in "obsolete or erroneous" determinations, with resulting "discriminatory distinctions in tax liability, and * * * litigious confusion" (333 U.S. at 599). The Court was accordingly careful to circumscribe the operation of the doctrine in tax litigation. Not only did it rule that the bar of estoppel was averted by even the most technical factual differences (*id.* at 600), but it also envisioned a variety of subtle changes in law any one of which would lift the bar, as where (*ibid.*) "a judicial declaration intervening between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable," or where there is "a modification or growth in legal principles as enunciated in intervening decisions of this Court." The Court cautioned (*ibid.*) against "neglecting legal modulations by this Court" and against "blind reliance upon the rule of collateral estoppel."

In its first CBN opinion the Court of Claims opened its discussion of the law by declaring that it "is made clear" in *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, that to claim an economic interest the taxpayer need not have title to the property (Pet. App. C, pp. 12c–13c). The Court of Claims further observed

(Pet. App. C, p. 15c, n. 5) with respect to *Southwest* that

> * * * the owner of the upland site had no title or ownership in the underwater oil. It simply contracted as an upland owner to furnish the site for the drilling equipment and machinery and was to receive a percentage of the net profits. * * * [T]he Supreme Court held that the upland owner who merely owned the site was entitled to its proportion of the depletion and the leaseholder to the balance. The Court does mention in Southwest that the site furnished was essential to the drilling contract, but this was the only one of the elements mentioned by the Supreme Court.

Principally on the basis of its reading of *Southwest Expl. Co.*, the court in the first CBN decision deemed it wholly immaterial for the purposes of the depletion allowance whether or not a taxpayer has acquired *ownership* of a property interest, in fee or leasehold, and whether or not a taxpayer without a legal property interest has made an investment or contribution to production which is essential thereto. The court concluded that the 1952 contract had the legal effect of vesting in CBN a depletable interest, *i.e.*, "the equivalent of an overriding royalty," the *quid pro quo* for this being the relinquishment of CBN's pre-1952 contractual right to purchase residue gas for use or resale (Pet. App. C, p. 16c).

The court misread *Southwest*, however, overlooking important qualifications in this Court's opinion. This Court had stressed (350 U.S. at 314–315) "that in each of the prior cases where the taxpayer has had a suf-

ficient economic interest to entitle him to depletion, he has once had at least a fee or leasehold in the oil-producing properties themselves." In ruling that the upland owners in the case before it (who had no fee or leasehold interest) acquired a depletable "economic interest," this Court had further limited its holding (*id.* at 317):

> We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.

Moreover, this narrow holding was prefaced by a warning that the Court was not promulgating any general principle which would extend the depletion allowance to taxpayers "disassociated from the lease" solely because they contributed facilities or an investment which might in some sense be considered essential to production (*id.* at 317).

The scope of *Southwest* was clarified in *Paragon Coal Co.* v. *Commissioner,* 380 U.S. 624, decided a year after the first CBN ruling. In *Paragon* the Court held that contract miners without an interest in the leasehold did not acquire a depletable "economic interest" by installing their own equipment for extraction of coal. So holding, the Court distinguished *Southwest* in language emphatically relating the up-

land owners there involved to the leasehold (380 U.S. at 638):

> We held that Southwest's right to drill being expressly conditioned by law upon the agreements with the upland owners made the latter *essential parties to the lease* from the State and was a *sufficient investment by them in the obtaining of the lease* to give them an economic interest in the oil in place * * *. [Emphasis added.]

Shortly before the *Paragon* decision, the Court of Claims itself receded from its broad reading of *Southwest*. In *Tidewater Oil* v. *United States*, 339 F. 2d 633 (Pet. App. D), the court stated (Pet. App. D, pp. 10d–11d):

> * * * aside from *Southwest Exploration* no Supreme Court decision has found a taxpayer possessing the requisite interest in the mineral in place who did not have either a fee or a leasehold interest in the oil-producing property itself. * * * [T]he upland owners in that case contributed *real property* which was essential to the *discovery, drilling,* and *extraction* of the oil. Without their participation, there would have been no lease, no wells and no production. * * * [T]he Court cautioned that they were not taking a drastic step from prior doctrine * * *. [Emphasis in original.]

We submit that the decisions in *Paragon* and *Tidewater Oil,* when compared with the first CBN decision, reflected a sufficient "change in legal atmosphere" to avert the bar of collateral estoppel and permit the Court of Claims to correct in the instant liti-

gation its evident misreading of *Southwest* in the earlier decision involving this taxpayer. *Riddell* v. *Monolith Portland Cement Co.*, 371 U.S. 537; *McCall* v. *Commissioner*, 312 F. 2d 699 (C.A. 4). Little purpose would be served, in our view, by further review of the collateral estoppel question, if only because it necessarily turns upon the particular and unlikely-to-recur facts and circumstances of this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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